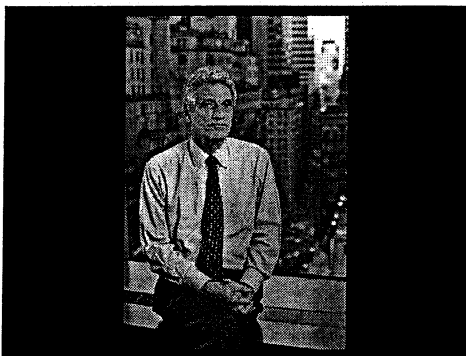


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## Hidden Pension Fiasco May Foment Another \$1 Trillion Bailout

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By David Evans



March 3 (Bloomberg) -- **The Chicago Transit Authority** retirement plan had a \$1.5 billion hole in its stash of assets in 2007. At the height of a four-year bull market, it didn't have enough cash on hand to pay its retirees through 2013, meaning it was underfunded to the tune of 62 percent.

The CTA, which manages the second-largest public transit system in the U.S., had to hope for a huge contribution from the Illinois state legislature. That wasn't going to happen.

Then the authority found an answer.

"We've identified the problem and a solution," said CTA Chairman Carole Brown on April 16, 2007. The agency decided to raise money from a bond sale.

A year later, it asked Illinois Auditor General **William Holland** to research its plan. The state hired an actuary, did a study and, on July 17, concluded that the sale of bonds would most likely result in a loss of taxpayers' money.

Thirteen days after that, the CTA ignored the warning and issued \$1.9 billion in bonds. Before the year ended, the pension fund was paying out more to bondholders than it was earning on its new influx of money. Instead of closing its funding gap, the CTA was falling further behind.

Public pension funds across the U.S. are hiding the size of a crisis that's been looming for years. Retirement plans play accounting games with numbers, giving the illusion that the funds are healthy.

The paper alchemy gives governors and legislators the easy choice to contribute too little or nothing to the funds, year after year.

### 30 Percent Shortfall

The misleading numbers posted by retirement fund administrators help mask this reality: Public pensions in the U.S. had total liabilities of \$2.9 trillion as of Dec. 16, according to the **Center for Retirement Research** at Boston College. Their total assets are about 30 percent less than that, at \$2 trillion.

With stock market losses this year, public pensions in the U.S. are now underfunded by more than \$1 trillion.

That lack of funds explains why dozens of retirement plans in the U.S. have issued more than \$50 billion in pension obligation bonds during the past 25 years -- more than half of them since 1997 -- public records show.

The quick fix for pension funds becomes a future albatross for taxpayers.

In the CTA deal, the fund borrowed \$1.9 billion by promising to pay bondholders a 6.8 percent return.

The proceeds of the bond sale, held in a money market fund, earned 2 percent -- 70 percent less than what the fund was paying for the loan.

The public gets nothing from pension bonds -- other than a chance to at least temporarily avoid paying for higher pension fund contributions. Pension bonds portend the possibility of steep tax increases.

#### 'Very Risky'

By law, states must guarantee public pension fund debts.

"What appears to be a riskless strategy is actually very risky," says **David Zion**, director of accounting research for New York-based Credit Suisse Holdings USA Inc. "If the returns on the pension bond-financed assets don't exceed the cost of servicing the debt, the taxpayers bear the brunt."

With the recession that started in December 2007, cities and states are running huge deficits, which they're closing by cutting services and firing employees. The economic downturn gives state legislatures another reason to cut back on funding pensions.

Government retirement plans nationwide don't calculate their shortfalls based on market values of their assets and liabilities, says **Orin Kramer**, chairman of the New Jersey State Investment Council, which oversees that state's pension fund.

#### Paper Over Losses

Fund accountants resort to a grab bag of tricks to get by. They set unrealistically high expected rates of return to reduce governments' annual contributions. And they use smoothing techniques to paper over investment reverses so they make losing years look like winners.

Accountants do that by averaging gains and losses, usually over a five-year period -- sometimes for as long as 15 years of investment returns.

That means actual results of any one year aren't used to calculate how much a state legislature contributes, which can delay governments catching up with losses for more than a decade.

This ruse can pass the buck to future taxpayers, who will pay for the retirement benefits of today's government workers.

"There are accounting gimmicks in pension land which create economic fictions and which disguise the severity of the real problem," Kramer says. "Unfortunately, pension board members don't have much of an appetite for disclosing inconvenient truths."

#### Calpers' Numbers

The **Teacher Retirement System of Texas**, the seventh-largest public pension fund in the U.S., reports each year that its expected rate of return is 8 percent. Public records show the fund has had an average return of 2.6 percent during the past 10 years.

The nation's largest public pension fund, California Public Employees' Retirement System, has been reporting an expected rate of return of 7.75 percent for the past eight years, and 8 percent before that, according to **Calpers** spokesman **Clark McKinley**.

Its annual return during the decade from Dec. 31, 1998, to Dec. 31, 2008, has been 3.32 percent, and last year, when markets tanked, it lost 27 percent.

#### 'It's Pitiful'

"It's pitiful, isn't it?" says **Frederick "Shad" Rowe**, a member of the Texas Pension Review Board, which monitors state and local government pension funds. "My experience has been that pension funds misfire from every direction. They overstate expected returns and understate future costs. The combination is debilitating over time."

Rowe, 62, is chairman of Greenbrier Partners, a private investment firm he founded in Dallas 24 years ago.

Texas teacher retirement fund spokesman **Howard Goldman** and Calpers's McKinley declined to comment on Rowe's views.

Most public pension funds, like the one in Chicago, were already trading water before the 2008 stock market crash. Now they're closer to sinking.

State government pension fund assets in the U.S. fell 30 percent in the 14 months ended on Dec. 16, losing \$900 billion, according to the Center for Retirement Research.

Fund managers don't have many options for increasing assets. They need adequate funding from state legislatures, which in many cases they don't get. Beyond that, they're at the mercy of financial markets.

#### Easy Money

Typically, public pension funds put 60 percent of their assets in stocks, 30 percent in fixed income, 5 percent in real estate and the rest in riskier investments such as hedge funds and commodities.

That mix requires the nonbond assets to earn double-digit gains in order to reach expected rates of return.

The easiest way for retirement plans to increase cash is to issue pension obligation bonds. For the funds, that means borrowing money at no risk -- because the bonds are backed by taxpayers.

A government retirement plan can't go bankrupt, even if it's insolvent; state treasuries must put up the money if a fund runs dry.

What for retirement plans in the U.S. has been a simple solution -- issuing \$50 billion in pension bonds -- has become a growing headache for the public.

#### 'Where Did The Money Go?'

"When the actuary is finished with his magic, where did the money go?" asks **Jeremy Gold**, who was one of the first actuaries to work for a Wall Street firm when he joined **Morgan Stanley** in 1985.

The answer, he says, is that future taxpayers may cover what fund administrators had hoped to get from investment returns.

For investors, these debt sales are similar to ordinary municipal bonds. Because both forms of debt are ultimately backed by taxpayers, credit rating firms give them high grades for safety. The difference for bondholders in states is that pension bonds aren't tax-exempt.

General obligation bonds are typically used to pay for construction of schools, hospitals and other public works; pension bonds just fund needy retirement plans. For that reason, Congress decided in 1986 that pension bond income should be subject to federal income taxes.

Government officials say they issue pension bonds believing that their fund managers can earn more money from investing the proceeds than what they have to spend in interest payments to bondholders.

#### 'Risk Is Minimal'

The government of Puerto Rico borrowed \$2.9 billion through pension bonds in 2008, betting that it could reap annual returns of 8.5 percent investing the money, while paying its bondholders 6.5 percent.

"The risk is minimal," says Jorge Irizarry, who was chairman of the Employees Retirement System of Puerto Rico from August 2007 through December 2008.

A political appointee, he departed after his party lost the governorship in November. Before working for Puerto Rico, Irizarry was an executive on the island at PaineWebber Group Inc., now UBS Puerto Rico, from 1986 to 1998.

So far, Puerto Rico's wager isn't paying off. The 8.5 percent expected rate of return has instead been a loss of more than \$200 million, according to a Dec. 12 presentation by fund administrators to legislators.

### 'Turned Against Us'

"It was an arbitrage transaction, and the market has turned against us," says **Carlos Garcia**, former president of Banco Santander Puerto Rico, who replaced Irizarry as chairman of the pension fund in January. "I don't know if the benefits intended will be realized."

Actuaries consistently permit public pension funds to report artificially high expected rates of return -- most often 8 percent and as much as 8.75 percent. That's more than the 6.9 percent billionaire investor **Warren Buffett** sets for his Omaha, Nebraska-based **Berkshire Hathaway Inc.**'s pension fund.

"Public pension promises are huge and, in many cases, funding is woefully inadequate," Buffett wrote in his 2008 letter to shareholders. "Because the fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that the problems will only become apparent long after these officials have departed."

Determining how much expected rates of return should be isn't complicated, says Rowe, who oversees Texas pension funds.

"Why do they choose high expected rates of return?" he says. "The only reason is to sneak through promising a lot to pensioners -- which means worrying about it later. It's madness."

### The Rules

**The Governmental Accounting Standards Board**, a nonprofit group that provides guidance for accountants, has rules for financial reporting by public pension funds.

A study commissioned by the U.S. Senate Finance Committee, released on July 10, 2008, found that GASB guidelines could be meaningless.

"GASB operates independently and has no authority to enforce the use of its standards," the report said. Each state sets its own rules. The GASB rules don't mention pension bonds.

Illinois sold the largest pension bond issue ever, \$10 billion in 2003, to shore up its state pension funds. In 2007, former Governor **Rod Blagojevich** proposed an even larger, \$16 billion pension bond issue, as the state's unfunded pension liability exceeded \$40 billion.

The legislature impeached Blagojevich in January after he allegedly sought bribes in return for filling President **Barack Obama's** vacant U.S. Senate seat.

### Ignoring Advice

When the Chicago Transit Authority decided to issue debt in 2008, it did its own calculations.

The CTA concluded it could borrow \$1.9 billion, paying an interest rate of 6 percent to bondholders, and invest the proceeds to receive its expected rate of return of 8.75 percent. Such an annual return would add \$52 million a year to bolster the fund.

The CTA chose to ignore not only Illinois's auditor general but also its own actuarial firm, Detroit-based Gabriel Roeder Smith & Co. The company had determined there was just a 30 percent chance of earning 8.75 percent.

"We executed the best transaction we could, given the legislative and political restraints," says CTA Chairman Brown, who is also co-head of municipal finance at Chicago-based **Mesirow Financial Inc.**

### Credit Crunch

Since the bond sale, the authority has held the money as cash, earning 2 percent. And, with the credit crunch forcing municipal bond interest rates up to attract buyers, the CTA wasn't able to sell bonds with a 6 percent return.

A team of underwriters, including **Goldman Sachs Group Inc.**, **JPMorgan Chase & Co.** and Morgan Stanley, sold the CTA bonds in August 2008, at a yield of 6.8 percent, so the fund had to pay bondholders more than it had expected.

"There is negative arbitrage," Brown says. "It's better than having dumped the money into the equity market."

The one group that benefits from the pension bond sales is the CTA's retirement plan members. The authority is responsible for contributing more than twice as much to the fund as its employees. Thus the retirees are virtually certain to enjoy pension contribution savings from the pension bonds, the auditor general's report says.

#### Puerto Rico Mistakes

Neither workers nor the government are thrilled with the public pension system in Puerto Rico. As of 2005, the Caribbean island's government pension, with 278,000 participants, had assets that totaled just 19 percent of its long-term liabilities. That made it less funded than any state retirement fund in the U.S., public records show.

Puerto Rico's pension system is a model for common mistakes made by public funds across the U.S.

Puerto Rico, a U.S. commonwealth with a population of 4 million, has underfunded its main public pension fund since 1951 to save cash.

The island, whose capital building in Old San Juan is as close to the turquoise ocean waves as are the tourists taking photos on the edge of the beach, is far from being a financial paradise.

The legislature has repeatedly ignored annual suggested contributions calculated by its own actuaries, according to the Employees Retirement System's records.

#### Boosting Benefits

Puerto Rico's legislature raised pension benefits without funding the increased expense 30 years ago. Edmund Garza, the retirement system's administrator from 1992 to 1996, says pensions were boosted from 45 percent of average salary to 75 percent after 30 years of employee service.

"They didn't prepare a detailed actuarial analysis to see the financial impact of this decision, but definitely it was huge," Garza, 47, says.

The government skipped nearly \$2 billion in contributions urged by its actuaries from 2000 to '05, according to fund records. The pension system continued a course toward insolvency as it paid out more in benefits than it took in.

By 2005, the Employees Retirement System had \$12.3 billion of pension obligations with just \$2.3 billion of assets. Puerto Rico itself has a BBB- credit rating, one notch above junk, from Standard & Poor's.

"We are very near bankruptcy," says economist Jose Villamil, speaking of the commonwealth. He is founder of Estudios Tecnicos Inc., a San Juan-based economics consulting firm. "The budget is out of control; the treasury is in sad shape."

#### 'Continue to Deteriorate'

In 2007, the actuary for the Puerto Rico fund, Hector Gaitan of **Buck Consultants LLC**, recommended that the legislature make an annual contribution of \$564 million.

"The financial status of the System will continue to deteriorate," Gaitan said in a Feb. 12, 2007, letter to the pension board that urged a boost in commonwealth contributions.

The legislature ignored Gaitan's warning. It chose to put \$398 million into the pension fund. Just months after Gaitan suggested bigger government contributions to the retirement system, the pension board dismissed Gaitan and his firm.

"Those comments may have gotten us in trouble," says Gaitan, seated at his desk in a small cramped office in a San Juan business park landscaped with palm trees. "We were terminated shortly thereafter."

Irizarry, who chaired the fund's board until Dec. 31, declined to say why the board dismissed Gaitan.

### Outdated Mortality Tables

Gaitan says the retirement system's underfunding may actually be an additional \$1 billion or more than the fund reports, because the board relies on outdated mortality tables based on 1960s statistics to compute its future obligations. The shorter life spans in those outdated tables reduce the apparent size of the fund's liabilities.

The legislature has taken one step to improve pension funding -- on the backs of employees hired after Dec. 31, 1999. New employees are denied fixed annual pensions. They must self-fund their retirement accounts.

The legislature diverts 9.275 percent of salary pension contributions for new workers to help scrape together the money needed to provide pensions for pre-2000 employees. By not making pension payments to employees hired after 1999, the pension fund will cut future liabilities.

The states of Alaska and Michigan, like Puerto Rico, have eliminated traditional public pension funds for new employees in the past 12 years.

Ana Reyes, an attorney in Puerto Rico, decided to take a job with the city of Caguas in 2008 so she could lock into a government pension.

### 'My Insurance'

"I wanted to have a good life when I get old," Reyes, 33, says. "That was my insurance."

Reyes, who lives in the island's Central Mountain Range 20 miles (32 kilometers) south of San Juan, says she didn't know that new employees get no retirement payments funded by the government.

"If I'd known this, I might have made a different career decision," says Reyes, who is the mother of a 2-year-old girl. "When I started here, they didn't explain that."

Even states that have had fully funded pensions -- such as New Jersey in the 1990s -- now have retirement plans with fewer assets than future liabilities and aren't moving to plug the gaps.

### Jon Corzine

New Jersey Governor **Jon Corzine**, a former co-chief executive officer of Goldman Sachs, has proposed allowing government pension funds to put off half their pension contributions because of the state's growing deficit during the recession.

Corzine's suggestion follows a recent New Jersey pension track record of mistakes. When the state's pensions were healthy in the 1990s, the state legislature eliminated nearly all of its annual pension contributions for almost a decade, while adding \$4.6 billion of benefits.

New Jersey sold \$2.75 billion of pension bonds in July 1997. Then-Governor **Christine Todd Whitman** said at the time that the bonds would save taxpayers \$47 billion and make the system fully funded.

"You'd be crazy not to have done this," Whitman said in a Bloomberg News interview in June 1997. "It's not a gimmick. This is an ongoing benefit to taxpayers."

Whitman's prediction hasn't held up. While the state pays pension bondholders a fixed 7.64 percent interest rate, the fund has earned 4.8 percent annualized since the bond sale, according to Tom Bell, spokesman for the New Jersey Treasury Department.

### 'Outrageous Gimmick'

New Jersey's pension bonds haven't saved taxpayers \$47 billion. To date, the state has lost more than \$500 million on those bonds, according to state records.

"Governor Whitman came up with this outrageous gimmick in order to give people tax cuts," says Kramer, chairman of the board that oversees New Jersey state pension funds.

As the global economic crisis deepens, public pension funds will lose more money. The solution shouldn't

be more accounting tricks, Kramer says.

"Virtually every pension system has suffered losses in excess of 20 percent since they created the last set of artificial numbers," he says.

The best step forward would be for states to negotiate benefits down, increase pension contributions and reduce the expected rate of return, Texas pension oversight board member Rowe says.

Public pension funds have to stop pushing the costs of retirement benefits for current workers into the future, actuary Gold says.

"You're putting a bigger burden on your children," he says. "It amounts to a transfer from tomorrow's taxpayers to today's employees."

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To contact the reporter on this story: **David Evans** in Los Angeles at [davidevans@bloomberg.net](mailto:davidevans@bloomberg.net)

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